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Written Testimony

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"Sarbanes-Oxley Section 404: Will the SEC's and PCAOB's New Standards Lower Compliance Costs for Small Companies?"
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Chairman Velazquez, Ranking Member Chabot and members of the Committee. Thank you for providing the opportunity to testify before you today on reforms to the Sarbanes-Oxley Act (SOX) Section 404 adopted by the Securities and Exchange Commission and Public Company Accounting Oversight Board.

I am Jim Greenwood, President and CEO of the Biotechnology Industry Organization (BIO). I am privileged to be here today on behalf of BIO, an organization representing more than 1,100 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 50 U.S. states and 31 other nations. BIO members are involved in the research and development of health care, agricultural, industrial, and environmental biotechnology products. The majority of BIO member companies are small, research and development oriented companies pursuing innovations that have the potential to improve human health, expand our food supply, and provide new sources of energy. The promise of biotechnology is immense, as our members combine biology and technology to deliver new treatments for unmet medical needs, improved crops that are more drought resistant and have reduced environmental impact, and create cheaper, more environmentally friendly fuels and consumer products. Biotech is one of the most innovative high growth sectors of our nation's economy, and one in which the United States maintains a global leadership position.

At the outset, let me mention that BIO appreciates the Committee's efforts and vigilance regarding the implementation of Sarbanes Oxley Section 404. Also, my testimony today has greater specificity with respect to the PCAOB rules than it does the final rule approved by the SEC, as the SEC's rule is not yet available for public viewing. I note that it is surprising that in this day and age it is not possible for a major Federal agency to make the text of the rule it has formally approved available on the same day in which it takes action.

First, I'd like to start by providing a short answer to the Committee's question, posed in the title of this hearing, as to whether or not the SEC's and PCAOB's new standards will

lower compliance costs for small companies. In summary, the answer is a marginal "yes."

There has been considerable rhetoric from both the SEC and PCAOB that has accompanied these rules, and we appreciate the recognition of the many problems caused by the poor implementation of Sarbanes Oxley Section 404. The changes promulgated by the two agencies are well-intended, though they appear modest in effect. Ultimately, the rhetorical promises offered can only be kept if there is an on-going, consistent effort and commitment to reducing unneeded audit and compliance costs.

BIO fully appreciates and agrees with the Congressional intent behind Section 404 – to enhance investor protection and confidence. BIO members strongly support this goal. As this Committee well knows, though, where Section 404 has gone awry is in the implementation. The situation that many emerging biotech companies face is that funds that would be otherwise spent for core research and development of new therapies for patients are instead used for overly complex controls or unnecessary evaluation of controls. This legislation – for which I was a conferee in 2002 – was not intended to be a windfall for auditors, nor pile on the compliance costs for companies. As we all know, that was not our desire when we wrote this law. Indeed, the Senate Banking Committee report on the legislation specifically stated that with respect to Section 404, "the Committee does not intend that the auditor's evaluation be the subject of a separate investigation or the basis for increased fees." [1]

However, the scale of the problems that Section 404 has created suggests that Congress should closely monitor the implementation of these revisions to ensure that its original intent is achieved. It is critical to ensure that these new rules provide the greatest possible flexibility and scalability for small public companies.

Consequences of One-Size-Fits-All Approach to the Industry and U.S. Competitiveness

The one size fits all approach originally implemented by the PCAOB in its Auditing Standard #2 (AS-2) created checklist mentality to audits that increased both financial and manpower costs without appreciably improving financial reports or internal controls. These costs have been recognized, and documented last year, by the SEC Advisory Committee for Smaller Public Companies (Advisory Committee), which found that, "with more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of Section 404 compliance, [small] companies have been disproportionately subject to the burdens associated with Section 404 compliance."[2]

In addition, the U.S. Government Accountability Office issued a significant study last April that found that many small businesses had seen audit costs jump significantly, due

[1] S. Rep. No. 107-205 at 31 (2002).
[2] Final Report of the Advisory Committee on Smaller Public Companies. April 2006. Page 23.

in large part to the implementation, rather than the compliance with the intent, of Section 404.[3]

For most biotechnology companies, the actual costs of Section 404 compliance, including both internal costs as well as external auditor costs, are substantial. In fact, the opportunity costs of Section 404 for smaller companies can be even greater, impeding the ability to invest in and sometimes, to continue ongoing, critical research and development activities. Another member company's experience shows the opportunity costs of Section 404 compliance. This company not only spent approximately $500,000 on its external attestation of internal controls but also had to endure additional costs in terms of (i) the reassignment of laboratory research personnel to perform internal control work dictated by AS-2 and the company's external auditors, (ii) the postponement of the hiring of 5-10 additional researchers, and (iii) the delay of promising R&D programs. Such diversion of resources away from research activities can delay critical product development and has, in turn, a detrimental effect on a company's ability to raise capital.
Biotech companies are at the forefront of developing new treatments for many diseases, and biotech companies presently are engaged in over 350 clinical trials for over 200 diseases, from cancer to multiple sclerosis.

Under the requirements of Section 404, significant time and money are spent to put in place complex systems and processes dictated by the AS-2and required by external auditors. Let me give one example as a reminder of manifest flaws of the current system: one of BIO's member companies had five employees working on Section 404 compliance at a cost of approximately $1 million per year. This company estimated that its controller spent approximately 35% of his time on Section 404, while the CFO spent approximately 20% of his time. To complete the mandated internal control processes and the "checklist" dictated by AS2, the company had to increase its accounting staff by 40%. Further, this company reports only a 7% decrease in costs in year two as compared to its first year of compliance.

It is also the experience of BIO members that the current problems with Section 404 are not merely growing pains where the costs and burdens will decrease once the auditors and companies become more familiar with the process and requirements. The current implementation of Section 404 imposes the same requirements, steps and reviews on all companies, by the same individuals year after year. As a result, the costs are fixed and ongoing, impacting the long-term investment resources of microcap and smallcap companies.

For the investors, their confidence and trust in public companies may have increased as a result of the passage of SOX as a whole and not necessarily due to Section 404. The other provisions in SOX include whistleblower protections, increased enforcement powers, auditor independence requirements and, perhaps most importantly, CEO and CFO certifications of company financial statements under section 302 of SOX. As we saw in

[3] U.S. General Accountability Office, "Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies." April, 2006. GAO-06-361

the first and second years of Section 404 implementation, investors and the market generally had little market reaction when a company reported a "material weakness" in internal controls under Section 404. As discussed above, the costs of the implementation of Section 404, particularly for smaller public companies, appear to outweigh many of the benefits that are directly related to Section 404.

SEC and PCAOB's New Standards

Scaled Reform Needed for Smaller Public Companies

Both the SEC and PCAOB have taken steps to address the problems that have manifest from the implementation of Section 404. BIO commends both the SEC and PCAOB for taking to the steps to address the critical compliance problems that Section 404 audits had been creating, particularly for small and newly public companies. Both agencies suggest that these new requirements are to be "scaled", "risk-based" and "flexible". While the SEC's final guidance appears to provide a more flexible, principles-based set of rules for management, the new standards adopted by the PCAOB - while an improvement over the current standards – could still be improved to enhance flexibility, auditor judgment and consistency with SEC guidance. Furthermore, one could fairly say that in its revisions to its initial December 2006 draft, the PCAOB has taken a step back.

Removal of Small Company Definition – A Worrisome Signal?

Included in both the Commission's and the PCAOB's *proposals* were objective measures auditors could use in determining what is a "smaller company" – mainly, one with a market capitalization of less than $700 million and reported annual revenues of $250 million or less.[4] This was consistent with the recommendation of the Advisory Committee on Smaller Public Companies who suggested that an objective test – particularly a "revenue filter" - be used as a tool to define a smaller public company when scaling the audit.[5]

Unfortunately, this definition of a small company has been removed from the final PCAOB adopted rule. Ostensibly, this appears to have been done in order to encourage auditors to consider scaling the audit for the non-complex entities within large corporations. BIO certainly applauds that.

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[4] See footnote 44 of SEC proposal. File No. S7-24-06. http://www.sec.gov/rules/proposed/2006/33-8762.pdf and Paragraph 9 of PCAOB proposal. Release No. 2006-007. http://www.pcaob.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf

[5] See page 15 of the Advisory Committee on Smaller Public Companies. http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf

But rather than maintaining the proposed objective definition of a smaller company and then expanding it to include the subjective criteria that could also be applied to parts of larger companies, the PCAOB removed the objective criteria altogether.

In other words, under the December proposal, the PCAOB had suggested no less than six indicators[6] that a company could receive audit treatment proportionate to a less complex company:

- Market cap of $700 million and annual revenues of $250 million [7]
- Few business lines;
- Less complex business processes and financial reporting systems;
- Centralized accounting functions;
- Extensive involvement by senior management in the day-to-day activities of the business; and,
- Few levels of management, each with a wide span of control

In dropping any reference to market capitalization or annual revenues, the PCAOB appears to have deleted the only objective criteria for scalability included in the rule incomplete it may have been. In doing so, the PCAOB seems to have changed the presumption that a company meeting those thresholds is a "small company" and thus subject to a less burdensome audit to a presumption that everyone is subject to the fullest, most comprehensive audit – unless, they, the auditor – determines otherwise, using the subjective criteria in the rule.

To its credit, the PCAOB nevertheless continues to use discuss smaller public company issues throughout the rule – at least thirteen times by our count. Yet it is a startling failure on PCAOB's part that it chose to no longer provide any definition of smaller company, while maintaining the subjective definition of less complex companies,

BIO is disappointed that the final rule by the PCAOB removed the only objective criteria it had. The lack of clear direction to auditors is one problem that could be solved by adoption of a bright line test in which smaller companies could be assured of the ability to avail themselves of the scaled, proportionate audit of internal controls.

Maintaining the market capitalization and revenue criteria would have alleviated concerns with the potential conflict of interest relating to the incentives of the auditor who is charged with evaluating the "size and complexity of a company in planning and performing the audit" and also being the company providing the work.[8] In pursuing its incentive to maximize profits, an auditor has an economic incentive to determine a company too large and too complex, thus requiring an extensive audit mandating additional hours of billing, etc.

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[6] See Paragraphs 9 and 10 of PCAOB proposal Release No. 2006-007 (pages A1-7 and A1-8)

[7] See footnote 6 of PCAOB proposal in which they also reference definition of smaller public company as having a market capitalization of $787.1 million as used by the SEC Advisory Committee on Smaller Public Companies , Release No 2006-007 (page A1-7)

[8] See page 28 of the proposal. Proposal-2006-00 http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf.

In addition, some – like SEC Chief Accountant Conrad Hewitt as well as principals of the big accounting firms - have suggested auditors currently face unlimited exposure to legal liability and thus should receive some sort of limitation or cap on such liability.[9] While we make no policy judgment on that issue at this time, the mere consideration does suggest an auditor has great incentive to be overly ambitious with its internal control opinion in an effort to protect itself from such liability and the costs associated with litigation.

BIO would also note that auditors under PCAOB scrutiny tend to worry much more about being found deficient for having been too lenient with their audit clients rather than for being criticized for having been too rigorous or burdensome in their decisions. Accordingly, there is no incentive for an auditor to scale its audit because there are no penalties for being overly aggressive and creating unnecessary costs in an audit. The PCAOB should strongly consider how it evaluates auditors and examine how it could provide an incentive to be more efficient.

As result of this puzzling change, BIO believes that the new standards may do even less than the PCAOB's initial December 2006 initial revisions to counterbalance the incentives auditors face to be overzealous in their work. Consequently, while hoping for greater impact, it is unclear that the PCAOB's rules will lead to substantially lower audit fees or reduced burden on emerging biotech companies.

BIO believes a quantitative, objective standard for smaller public companies creates a much needed burden on the auditor to prove that a company falling within the pre-established thresholds has significant complexities that warrant a more detailed audit of the company's internal controls. Establishing quantitative measures relieves the PCAOB of the full burden of determining if auditors are in fact using their judgment to ensure shareholders, who ultimately carry the costs of the audit, are receiving value from a more complex audit.

It is BIO's view that by establishing quantitative measures as part of the consideration in scaling the audit, the auditor should look at a company within the established measures as a non-complex unit before their walkthrough. During the walkthrough, an auditor would be forced to seek reasons to increase the depth of the audit due to particular complexities of the company rather than look at all companies as a complex unit until proven otherwise by an auditor.

Product Revenue: A Better Indicator of Complexity

BIO has consistently advocated for scalability indicia that are most reflective of complexity. BIO supports the PCAOB's work to include the scalability criteria and guidance throughout the auditing standard. In order to achieve the benefits of the

[9] See Taub, Stephen. CFO.com "SEC's Hewitt: Indemnify the Big Four," CFO.com, Stephen Taub 26 January 2007; and www.pwc.com, "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks" November, 2006.

scalable approach, it is imperative that the auditors be encouraged to do so throughout the audit. Doing so minimizes the combined threat of litigation and PCAOB examination based upon terms and definitions that are mandatory and inflexible, and discourages auditors from using the maximum degree of checklist compliance.

BIO recognizes the efforts made by both the SEC and PCAOB to affirmatively attempt to reduce the audit and compliance burdens on all companies, specifically by focusing on the complexity of a company. However BIO believes by removing all objective measures established in the proposals, AS/5 has seen an "about-face" from the positive aspects the small business section of the proposal brought to the table.

As stated in our February 2007 comment letter, BIO believes that both the SEC and PCAOB should recognize product revenue as an important indicator of complexity in its own right. Rather than limiting auditor judgment by linking various attributes of smaller companies such as market capitalization and overall revenue, both agencies should be looking for ways to provide the indicia to auditors that operate both in conjunction and independently as proxies for complexity.

For these reasons, BIO does not see the real relief that our members need to support such an overarching rule.

More Consistent Definitions

At its April 4th, 2007 open meeting, the SEC authorized its staff to engage the PCAOB to improve the consistency of definitions in the 404 rules issued by both agencies. A multiplicity of standards and definitions that differ from those commonly employed in the area of financial reports themselves has contributed to the burdens associated with implementation of section 404.

BIO member companies had raised concerns that after changing auditors, they experienced new interpretations of "material weakness". Even within the context of a principles-based approach to auditing, some further clarification on this guidance was needed. We believe the clarification in the PCAOB adopted rule should accomplish this and laud the PCAOB for doing so.

BIO also commends the PCAOB for recognizing that its earlier standard – that an internal control deficiency had more than a "remote likelihood" of causing a misstatement was vague, confusing and resulted in unnecessary costs and audit burdens. BIO is pleased that both the SEC and PCAOB have adopted the same definitions of "materiality", "significant deficiency" and "material weakness".

Use of the Work of Others in an Integrated Audit

In our February 2007 comment letter, BIO urged the SEC and PCAOB to include in any reform of Section 404, that auditors be **required** to use the work of others such as management monitoring and testing that is done in accordance with SEC guidance.

BIO supports the PCAOB's work in agreeing to the use of one standard in evaluating the use of others work and by adopting a rule that allows auditors to use the work of others in the audit of internal controls over financial reporting as well as the integrated audit of financial statements. In addition, the PCAOB made progress in adopting a rule that allows for recognition of work of internal auditors, company personnel (other than internal auditors) and third parties working under the direction of management or the audit committee.

BIO does, however, remain concerned that the burden of determining the competency and objectivity of others work is placed solely on the shoulders of the auditor and leaves a great deal of subjective evaluation by the auditor in determining the competency and objectivity of others work. BIO believes that given the nature and structure of accounting firms, there remains no clear incentive for the auditor to recognize the work of others in conducting their audit of internal controls..

Use of Economic Cost-Benefit Studies

Lastly, BIO strongly believes that a rigorous economic study of the costs and benefits associated with implementation of Section 404 is imperative to understanding if the current reform proposals are meeting their objectives.

BIO would note here that the cost-benefit studies contained in the SEC proposal – and not even required in the PCAOB proposal – is wholly qualitative and lacks a quantitative analysis. Both agencies should be willing to engage in a true economic analysis of the cost and benefits associated with these proposals. Given the variety of other statutory requirements that both corporate management and outside auditors must comply with that pertain to the integrity of internal controls on financial reporting.[10] We commend SEC Commissioner Atkins in his questioning of the Commission's economic analysis and hope that he will continue to highlight this weakness during the Commission's consideration of AS/5.

Conclusion

BIO believes that these reforms are a marginal improvement over the current system of internal control audits but would note that the current system is so bad that any change is a marginal improvement. It is unclear, though not entirely likely, that these reforms will fully match the rhetoric surrounding their adoption. However, we remain hopeful that

[10] Section 13(b)(2)(B) of the Exchange Act requires, as it has since 1977, that public companies maintain a system of internal controls that provide reasonable assurances as to the accuracy of financial reports. This framework provides additional assurance to investors in a cost effective and risk based way to providing Section 404 relief for smaller public companies. Under SOX Section 302, each CEO and CFO must certify that the financial statements fairly present in all material respects the financial condition of the company, and they have disclosed all weaknesses in the internal controls which could be reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information, among other items.

this is just the first of several steps both the PCAOB and the SEC will take to continue refining their rules and reducing the unnecessary burdens placed on America's emerging and innovative companies. In conjunction with their further improvement of the PCAOB's rule, we urge the SEC to provide an additional exception for non-accelerated filers.

The evidence appears clear as to the consequences of allowing the process to stall here: innovation may be stifled and U.S. competitiveness compromised. The stakes for getting this right could not be higher; BIO believes that both agencies have taken important steps to get on the right track – and now the final adoption of reform lies in the hands of the Commission which has the ability to make the much needed changes mentioned in our testimony today. Nevertheless, good intentions only go so far. Consistent oversight into the application of these new rules and consequent appreciation of how they are continuing to impact capital formation particularly for small companies will be critical to restoring the U.S. to its proper primacy in the global capital markets.

Thank you for your time and consideration of BIO's views. I would be happy to answer questions that the Committee may have